In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 433

THE SHAMROCK OIL AND GAS CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Two issues are presented in this case.[1] The first—the so-called "depletion issue"—concerns the proper computation of a "representative market or field price" to be used in determining the taxpayer's "gross

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[1] Although it limits its argument to two issues, taxpayer states (Pet. 2, fn. 2) that it considers certain other issues as "preserved". These issues are fully dealt with in the Tax Court opinion (35 T.C. 979).

income from the property" upon which its percentage depletion allowance is based. The second—the "bonus" issue (Pet. 9)—relates to the proper treatment, for income tax purposes, of lease bonuses paid in connection with the acquisition of oil and gas leases. The decision below, rejecting the taxpayer's contentions, is in full accord with the governing Treasury Regulations and the decided cases. There is no reason for further review of the case by this Court.

1. Under the pertinent Treasury Regulations,[2] the percentage depletion base for oil and gas—the "gross income from the property" [3]—consists of the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well and, if he does not sell the oil and gas on the property, "the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation". In the present case, where it was necessary to determine the representative field price of gas, the court below (Pet. App. A-8 to A-9) approved use of a weighted average of actual prices paid at the wellhead during the years in question by purchasers of raw gas, including the taxpayer itself. Taxpayer does not question use of a weighted average but contends (Pet. 6-9) that the courts below erred in approving a computation of the weighted average which included prices paid pursuant to contracts negotiated in earlier years. Apparently it is taxpayer's view that these

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[2] Treasury Regulations 118 (1939 Code), Section 39.23(m)-1(e)(1).

[3] Internal Revenue Code of 1939, Section 114(b)(3), 26 U.S.C. 1952 ed., Section 114.

prices should be excluded on the theory that had the sellers of raw gas been free to renegotiate their older contracts in later years they might have been able to increase the contract price. The fact is, however, that these prices were paid during the taxable years and that it was entirely reasonable to take them into account. The computation approved by the court below was an average which gave weight to economic and technological changes to the extent reflected in actual sales. This approach is in accord with prior decisions (see *Shamrock Oil & Gas Corp.* v. *Coffee*, 140 F. 2d 409 (C.A. 5th); *Hugoton Production Co.* v. *United States*, 315 F. 2d 868 (C. Cl.)) and carries out the basic congressional purpose as interpreted in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76; that is to say, it puts taxpayer on a par with the average (neither high nor low) non-integrated producer who sells at the wellhead.

2. The taxpayer-lessee contends (1) that the lease bonus it paid its lessor is excludible from its taxable gross income and, if not, (2) that it must be included in its percentage depletion base (its gross income from the property). Under the pertinent Treasury Regulations,[4] production income in the amount of the lease bonus is included in the lessor's depletion base and excluded from the lessee's depletion base. On the other hand, the lease bonus is a capital investment as to the lessee and therefore cannot be deducted from taxable gross income received by him as lessee

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[4] Treasury Regulations 118 (1939 Code), Sections 39.23 (m)-1(e)(5) and 39.23(m)-10(a) and (b).

(which includes the amount of production income included in the lessor's depletion base). Thus the result is that, although an amount of production income equal to the lease bonus must be excluded from the lessee's depletion base for percentage depletion purposes, that amount, nevertheless, constitutes taxable income to the lessee.[5] This conclusion has been reached by every court of appeals which has passed upon the point (see *Canadian River Gas Co.* v. *Higgins*, 151 F. 2d 954 (C.A. 2d), certiorari denied, 327 U.S. 793; *Sunray Oil Co.* v. *Commissioner*, 147 F. 2d 962 (C.A. 10th), certiorari denied, 325 U.S. 861; *Murphy Oil Corp.* v. *United States*, 337 F. 2d 677 (C.A. 8th), certiorari denied, 380 U.S. 979) and this Court has repeatedly denied review. For a further discussion of the issue, we respectfully refer the Court to the memorandum in opposition recently filed by the United States in the *Murphy Oil* case. Oct. Term, 1964, No. 899.

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[5] Inherent in the rule so established is the fact that although both parties, as here, have realized income in the amount of the lease bonus—the lessor from the bonus itself and the lessee from actual operations under the lease—only one depletion deduction can be given on a given unit of oil production. The Commissioner, under a statutory grant of authority calling for an apportionment of the depletion allowance between lessor and lessee, has allocated the allowance on that part of production represented by the amount of the bonus to the lessor; consequently, since the lessee cannot also take depletion on these same units, it must subtract this amount from its base for percentage depletion purposes. Internal Revenue Code of 1939, Section 23(m); Treasury Regulations 118 (1939 Code), Section 39.23(m)-1(e)(5).

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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